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No. 227

In the Supreme Court of the United States

OCTOBER TERM, 1947

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOSEPH SUNNEN

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

The Acting Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Eighth Circuit entered in the above case on April 28, 1947.

OPINION BELOW

The opinion of the Tax Court (R. 62–72) is reported at 6 T. C. 431, and the opinion of the Circuit Court of Appeals (R. 92) is reported at 161 F. 2d 171.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on April 28, 1947 (R. 101). The jurisdiction of this Court is invoked under Section

240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The taxpayer assigned to his wife his interest in contracts under which his controlled corporation agreed to pay him royalties in return for nonexclusive and mutually cancellable licenses to manufacture and sell certain patented devices; the ownership of the patents was retained by him. The question is whether the Circuit Court of Appeals erred in reversing the decision of the Tax Court, entered pursuant to its finding that the royalties paid to the taxpayer's wife under these assignments in the taxable years 1937–41, inclusive (except for a small amount held excludible under the doctrine of *res judicata*), were in fact the taxable income of the taxpayer in those years.

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition.* — "Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any

business carried on for gain or profit, or gains or profits and income derived from any source whatever * * * (26 U. S. C. 1940 ed., Sec. 22).

SEC. 1141. COURTS OF REVIEW.

(a) *Jurisdiction.*—The Circuit Courts of Appeals and the United States Court of Appeals for the District of Columbia shall have exclusive jurisdiction to review the decisions of the Board,[1] except as provided in section 239 of the Judicial Code, as amended, 43 Stat. 938 (U. S. C., Title 28, § 346); and the judgment of any such court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari, in the manner provided in section 240 of the Judicial Code, as amended, 43 Stat. 938 (U. S. C., Title 28, § 347).

* * * * *

(c) *Powers.*—

(1) *To affirm, modify, or reverse.*—Upon such review, such courts shall have power to affirm, or, if the decision of the Board is not in accordance with law, to modify or to reverse the decision of the Board, with or without remanding the case for a rehearing, as justice may require (26 U. S. C. 1940 ed., Sec. 1141).

(Section 22 (a) of the Revenue Acts of 1938, c. 289, 52 Stat. 447, and of 1936, c. 690, 49 Stat. 1648,

[1] The name of the Board of Tax Appeals was changed to that of The Tax Court of the United States by Section 504 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798.

is the same as Section 22 (a) of the Internal Revenue Code.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

> SEC. 19.22 (a)–1. *What included in gross income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. (See sections 22 (b) and 116.) In general, income is the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets. Profits of citizens, residents, or domestic corporations derived from sales in foreign commerce must be included in their gross income; but special provisions are made for nonresident aliens and foreign corporations by sections 211 to 238, inclusive, and, in certain cases, by section 251, for citizens and domestic corporations deriving income from sources within possessions of the United States.. Income may be in the form of cash or property.
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> * * * * *

Article 22 (a)–1 of Treasury Regulations 101, promulgated under the Revenue Act of 1938, and Article 22 (a)–1 of Treasury Regulations 94, pro-

mulgated under the Revenue Act of 1936, are the same.

STATEMENT

The material facts in this case were stipulated (R. 25–50) and were so found by the Tax Court (R. 63). Their statement by the Tax Court (R. 63–69) may be summarized as follows:

During the taxable years Sunnen Products Company, a Missouri corporation (hereinafter referred to as "Company"), was engaged in the manufacture and sale of patented grinding machines and other tools. The taxpayer, a resident of Clayton, Missouri, held 1,780 out of a total of 2,000 shares of the Company's stock; his wife, Cornelia Sunnen, held 200 shares; and others connected with the Company held the remaining 20 shares. The Company's board of directors consisted of five members, including the taxpayer and his wife, and a vote of three was required to take binding action (R. 63–64, 66). It was stipulated that the directors were elected by the stockholders annually (R. 31–32).

In 1927, 1931 and 1939 the taxpayer, an inventor, had applied for patents on a cylinder grinder device, a pinhole grinder device, and a crankshaft grinder device, and subsequently patents were issued to him. He remained the owner of these patents through the year 1941. In 1939 the taxpayer applied for a patent on another crankshaft grinder device, and remained the owner of the application through the year 1941. (R. 64.)

By a written agreement dated January 10, 1928, the taxpayer granted the Company the right, license and privilege to manufacture and sell in the United States and foreign countries the "cylinder grinders" device, on which he had applied for a patent. In consideration of this license the Company agreed to pay to the taxpayer a royalty equal to 10% of the gross sales price of the device as it was "manufactured, sold and collected for." Both parties were given the right to cancel the license or to cease manufacturing thereunder, without liability, upon six months' notice in writing to the other party. In the absence of cancellation, the agreement was to continue in force for ten years (R. 64–65). Upon the expiration of this agreement in 1938, a renewal agreement with substantially the same terms was executed pursuant to which the Company was licensed to manufacture and sell the cylinder grinder for the balance of the life of the patent, i. e., until December 4, 1951 (R. 66).

Similar licensing agreements, except that the period for serving notice of cancellation was one year instead of six months, were executed by the taxpayer and the Company on December 5, 1931, with respect to the pinhole grinder device, and on June 20, 1939, with respect to the two crankshaft grinder devices. The Company was authorized by its board of directors to execute each of the license agreements (R. 64, 65, 66).

No notices of cancellation were given and all the licensing agreements remained in effect throughout the taxable years 1937–1941, inclusive, in accordance with their terms (R. 66).

On January 8, 1929, the taxpayer assigned to his wife "all my rights, title and interest in and to the Royalty which shall accrue hereafter to me" upon the royalty contract of January 10, 1928, with respect to the cylinder grinder device. On January 15, 1929, he advised the Company of the assignment (R. 66–67). On December 21, 1931, he executed a further assignment which recited that the Commissioner of Internal Revenue had raised some question as to the sufficiency and completeness of the previous assignment, and in which he confirmed the previous assignment, and assigned to his wife (R. 67–68)—

> all of my right, title and interest in and to said royalty contract of January 10, 1928 between myself and said Sunnen Products Company, relating to the manufacture of the cylinder grinder described in said royalty contract, for the calendar year 1931, particularly. And I hereby state that the royalties accruing under said royalty contract have heretofore been and are hereafter the sole and exclusive property of the said Cornelia Sunnen, and hereby declare that said royalties shall be paid to the said Cornelia Sunnen or to her order, and that she shall have the sole right to

collect, receive, receipt for, retain or sue for said royalties.

The taxpayer also executed written assignments, similar in form and substance to the assignment of December 21, 1931, purporting to assign all of his right, title, and interest in and to the royalty contracts with respect to the pinhole grinder and the two crankshaft grinders, and to the renewal royalty contract made in 1938 with respect to the cylinder grinder. In each case he notified the Company of the assignments (R. 68).

All the assignments were without consideration and were made as gifts to taxpayer's wife. The gifts made after 1932 were reported by taxpayer for gift tax purposes (R. 68).

In 1937 the Company paid to taxpayer's wife, pursuant to the assignments, royalties on the 1928 cylinder grinder contract in the amount of $4,881.35 and on the pinhole grinder license contract royalties of $15,518.68. In the taxable years 1938–1941, inclusive, no royalties were paid on the 1928 cylinder grinder contract, but royalties were paid to taxpayer's wife on the 1938 renewal cylinder grinder contract and on the pinhole and crankshaft grinder contracts in the total amounts of $17,318.80 in 1938, $25,243.77 in 1939, $50,492.50 in 1940, and $149,002.78 in 1941 (R. 68).

The taxpayer's wife included as her income on tax returns all of the royalties paid to her in the taxable years in which she received them. She

paid income taxes thereon, which have not been refunded to her (R. 69).

The taxpayer's returns for 1937, 1938, 1939, 1940, and 1941 reported net income of $30,616.03, $36,787.82, $42,229.35, $48,846.92, and $60,570.28, respectively (R. 13–17).

In a previous proceeding involving the taxpayer's income tax liability for the years 1929, 1930, and 1931, the Board of Tax Appeals held that the taxpayer was not taxable on the royalties paid to his wife in those years under the original license agreement of January 10, 1928, with respect to the cylinder grinder device (R. 53–60). It was stipulated that this opinion, and decisions rendered pursuant thereto, might be considered in this case to the same extent as if introduced in evidence (R. 69).

Upon these facts the Tax Court, one judge dissenting, held that all of the royalties paid to taxpayer's wife in each taxable year under the license agreements were in fact taxable income of the taxpayer, with the exception that the royalties of $4,881.35 paid in 1937 under the original cylinder grinder license contract were held to be excludable from his income in that year. This was on the theory that the principle of *res judicata* prevented treating these royalties as taxable income of the taxpayer in 1937, since in the former decision the Board had held that royalties paid under the same contract in the years 1929, 1930, and 1931 were not income of the taxpayer (R. 69–72).

The taxpayer appealed to the Circuit Court of Appeals, contending (1) that the Tax Court erroneously decided that the royalties paid to his wife in the taxable years under the license agreements constituted taxable income in fact to him; and (2) that the Tax Court erred in failing to hold that the former decision of the Board was *res judicata* that none of the royalties were taxable income to him in any taxable year. The Commissioner also appealed to the Circuit Court of Appeals from the portion of the Tax Court's decision which was adverse to him, contending that the Tax Court was not estopped by the doctrine of *res judicata* from including the royalties of $4,881.35, paid under the 1928 licensing contract, in taxpayer's income for 1937 (R. 80–82).

The Circuit Court of Appeals reversed the Tax Court's decision on the merits in the taxpayer's appeal, holding that the royalties paid to the taxpayer's wife in the taxable years were not income to the taxpayer (R. 92–99). In the Commissioner's appeal, the Circuit Court of Appeals affirmed the Tax Court, holding that the doctrine of *res judicata* prevented inclusion in taxpayer's income of the royalties of $4,881.35 paid in 1937 under the original cylinder grinder royalty contract (R. 99–100). In view of its decision on the merits, it was unnecessary for the court to decide the applicability of *res judicata* to the other royalties paid in the taxable years (R. 100–101).

SPECIFICATION OF ERRORS TO BE URGED

The court below erred:

1. In holding that the royalties paid to the taxpayer's wife were not in fact taxable income of the taxpayer in the taxable years, and in substituting its view for that of the Tax Court.

2. In holding that the principle of *res judicata* prevents taxation of the royalties of $4,881.35 paid in 1937 under the original cylinder grinder license contract to the taxpayer.[2]

REASONS FOR GRANTING THE WRIT

1. The decision of the Circuit Court of Appeals is in conflict with principles established in decisions of this Court. One who assigns the right to receive income, but retains ownership of the property producing that income, is, despite the assignment, taxable on the income when paid to his assignee. *Helvering* v. *Horst,* 311 U. S. 112; *Helvering* v. *Eubank,* 311 U. S. 122; *Harrison* v. *Schaffner,* 312 U. S. 579; *United States* v. *Joliet & Chicago R. Co.,* 315 U. S. 44; *Commissioner* v. *Tower,* 327 U. S. 280; *Lusthaus* v. *Commissioner,* 327 U. S. 293; *Lucas* v. *Earl,* 281 U. S. 111; *Burnet* v. *Leininger,* 285 U. S. 136; *Commissioner* v. *Harmon,* 323 U. S. 44. And the result is the same for tax purposes, even though

[2] This second error is not urged as a reason for granting certiorari, but it is set out here so that the Government will not be foreclosed from arguing if in the event a writ of certiorari is granted.

a legally perfect gift of income producing property has been made, where the transfer is an intrafamily arrangement leaving the assignor with incidents of control sufficient to support the conclusion that he is in substance the true owner of the property. *Helvering* v. *Clifford*, 309 U. S. 331; *Helvering* v. *Horst*, *supra*, pp. 116–117; *Harrison* v. *Schaffner*, *supra*, pp. 583, 584; *Commissioner* v. *Tower*, *supra*; *Lusthaus* v. *Commissioner*, *supra*; cf. *Burnet* v. *Wells*, 289 U. S. 670.

The facts of this case fit within these principles, as the Tax Court held. The royalties were paid for the nonexclusive privilege of manufacturing and selling certain patented devices, and the royalties were thus derived from the patents which taxpayer continued to own. The license contracts only fixed the amount of the income which would be earned by use of the patents. But even if the license agreements are regarded as property contributing to the production of the royalty income, the patents themselves cannot be wholly ignored as the substantial source of the royalties.[3]

[3] No case of which we are aware holds that the royalty contract in a situation of this kind is the exclusive source of the royalties. In *Washington* v. *Commissioner*, 80 F. 2d 829 (C. C. A. 2d), certiorari denied, 298 U. S. 689, and in *Estate of Dodson* v. *Commissioner*, 1 T. C. 416, dismissed September 1, 1943 (C. C. A. 5), it was assumed without deciding that this was so, but the assignor's control in connection with the contracts themselves compelled the conclusion that he was their substantial owner in those cases. The lower court, however, held (R. 95–96) that the royalty or

As in *Helvering* v. *Horst, supra,* which involved the assignment of interest coupons, the gift of a separate contractual right to payment of the income does not, where ownership of the basic property is retained, shift tax responsibility under Section 22 (a) of the Internal Revenue Code, *supra,* on the income to the assignee.[4] Clearly taxpayer would have been taxable if he had assigned the royalties themselves to his wife. The consequence should not be different because he achieves the same result by entering into con-

license contracts, and not the patents, produced the income, citing seven cases (R. 95) as authority. We think that none of these cases, assuming they were correctly decided, support the holding. The only one of them which involved an assigned patent royalty contract is *Nelson* v. *Ferguson*, 56 F. 2d 121 (C. C. A. 3), certiorari denied, 286 U. S. 565. That decision seems erroneous under subsequent decisions of this Court, but in any case there the patents themselves were transferred to a corporation, without right to sell, for exploitation in consideration of one-third of the net profits to be realized therefrom. Thus, it is unlike the present case wherein taxpayer retained the patents and nothing more than a cancellable, nonexclusive license to manufacture and sell was granted to the Company.

[4] In this connection, it is significant that, apart from a possible right to cancel the contracts if taxpayer's personal right to do so upon giving the prescribed notice passed to her, taxpayer's wife had no rights other than to collect and receive such royalties as became payable under the contracts. The license contracts do not require the Company to manufacture and sell any particular number of devices, and do not specify minimum royalties payable (R. 33–34, 36–37, 39–41, 43–44). Thus, they do not guarantee that the licensor or his assignee will receive a minimum, or indeed any, royalties from the licensee.

tracts for royalties with a family corporation, and then assigns the contracts.

The Tax Court's conclusion that the royalties were in fact the income of the taxpayer took into account not only his ownership of the patents, a point which it stressed (R. 72), but also his powers of control over the license contracts and the flow of income thereunder. On the facts as a whole its conclusion was the only one reasonably possible. As president of the Company and owner of 89% of its stock, and as owner of the patents, with rights *inter alia* to use them himself, to license others than the Company to do so, and to protect them against infringement, the taxpayer retained the power to regulate the Company's production and sales and to create competition with it; he thus controlled, even to the point of terminating, the royalties payable by the Company. Furthermore, his controlled corporation was authorized by the contracts to cancel the license on a year or six months' notice, thus empowering him to divest even the legal title of the assignee to the royalty rights.[5] Cf. *Corliss* v.

[5] The Circuit Court of Appeals improperly assumed that the powers of control were not substantial, on the theory that an attempted exercise of the powers would necessarily amount to a fraud on the Company or on the taxpayer's assignee, which would be enjoined or would inevitably be defeated by the other directors of the Company. The taxpayer might have caused a cancellation of the old contracts and have substituted new ones with more favorable terms to the Company; there would be no fraud on the Company in such case. More-

Bowers, 281 U. S. 376. Coupled with ownership of the patents and these powers of control are the circumstances that the licenses were of a temporary character; that the wife acquired in substance nothing more than the right to take the royalties; that the arrangement was a device to reallocate some of the husband's income to his wife for tax purposes (see R. 67), and that the assignments effect no material alteration of his economic status, the income all remaining in the close family group. Viewed realistically, the facts as a whole require the conclusion that the taxpayer was in every practical and substantial sense the owner of the entire interest in the property which produced the income.

The rule of *Blair* v. *Commissioner*, 300 U. S. 5, which the Circuit Court of Appeals followed, does not apply because there, as the Court pointed out, the donor assigned completely specified parts of

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over, the assignee would have no standing to complain of cancellation since her contractual rights were subject to the Company's right to cancel upon notice without incurring liability. Even if it is assumed, despite the apparently harmonious family relationship, that the taxpayer's wife as a director would vote contrary to his wishes, it may not be assumed that the other directors of the Company were not amenable to his will, particularly since the directors were elected annually by the stockholders (R. 31–32), and a recalcitrant director could thus be removed by the taxpayer, the controlling stockholder. Further, it seems undoubted that the taxpayer's rights as owner of the patents could be exercised without interference, since the Company had only non-exclusive licenses.

an equitable interest owned by him. Cf. *Harrison* v. *Schaffner, supra.* Here, the taxpayer's rights to his patents were not covered by the license agreements, and hence were not assigned. Nor is the lower court's analogy of an assignment of a lessor's interest in a lease (R. 96) entirely apposite here. We believe that the illustration given in *Helvering* v. *Horst, supra,* p. 119, refers to an assignment of his entire interest by the owner of only a leasehold.[6] Here, the taxpayer did not dispose of all of his present rights in the patents and he clearly should be taxable on the assigned royalties, as is the lessor of an easement, who has retained the right to grant to others use of the easement, taxable on the rents assigned to another. Cf. *Ward* v. *Commissioner,* 58 F. 2d 757 (C. C. A. 9), certiorari denied, 287 U. S. 656.

2. The judgment of the Circuit Court of Appeals reflects a clear abuse of the court's power of review under Section 1141 (c) (1) of the Internal Revenue Code, *supra,* and violates numerous decisions of this Court delineating the circumstances in which the Tax Court may be reversed.

[6] But even where a lessor owns a fee in the realty, he ordinarily has leased all of his present rights in the property or in a severable part thereof, and in such case a purported assignment of his interest in the leasehold has been held to carry with it the liability for tax on the rents. *Lum* v. *Commissioner,* 147 F. 2d 356 (C. C. A. 3), a case we believe to have been incorrectly decided, which illustrates the potentialities for tax avoidance of a scheme comparable to that involved here.

See *Commissioner* v. *Tower,* 327 U. S. 280; *John Kelley Co.* v. *Commissioner,* 326 U. S. 521; *Commissioner* v. *Court Holding Co.,* 324 U. S. 331; *Commissioner* v. *Scottish American Co.,* 323 U. S. 119; *Dobson* v. *Commissioner,* 320 U. S. 489, rehearing denied, 321 U. S. 231; *Helvering* v. *Stock Yards Co.,* 318 U. S. 693. Whether the bundle of rights resting in a donor invests him with sufficient powers of control to justify treating him for tax purposes as the substantial owner of the property and the income therefrom, despite the transfer of legal title to an assignee, does not present any "clear-cut question of law", but is one for the trier of the facts. *Helvering* v. *Clifford,* 309 U. S. 331, 336; *Helvering* v. *Stuart,* 317 U. S. 154, 169. Other Circuit Courts of Appeals have treated the question of whether the income is still attributable to the donor as a question of fact for the Tax Court. *Hash* v. *Commissioner,* 152 F. 2d 722 (C. C. A. 4); *Eisenberg* v. *Commissioner,* 161 F. 2d 506 (C. C. A. 3), certiorari applied for, No. 221, this Term; *Littel* v. *Commissioner,* 154 F. 2d 922 (C. C. A. 2). While the issue as to the real ownership of the income here turns on the ownership of the income-producing property, as well as on the donor's powers of control, it was plainly the Tax Court's function to weigh the facts and draw the conclusion. Cf. *Helvering* v. *Horst, supra; Commissioner* v. *Tower, supra.*

As we have shown, the Tax Court's finding that the royalties were in fact taxable income of the taxpayer has substantial support in, if it was not compelled by, the record facts. The finding was made with a correct understanding of the controlling legal principles. In these circumstances it was serious error for the Circuit Court of Appeals to substitute its own factual conclusion for that of the Tax Court.

3. The question presented in this case is an important one and should be settled by this Court. The method used by the taxpayer here to shift some of his income to his wife is adaptable to virtually every kind of property interest which may be licensed or leased, and, if successful taxwise, is likely to stimulate comparable plans to avoid taxes.

CONCLUSION

For the foregoing reasons it is respectfully submitted that the petition for a writ of certiorari should be granted.

GEORGE T. WASHINGTON,
Acting Solicitor General.

JULY 1947.

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